



**DEPARTMENT OF  
FINANCE**

ARNOLD SCHWARZENEGGER, GOVERNOR

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January 5, 2006

Mr. Michael C. Genest, Director  
Department of Finance  
State Capitol, Room 1145  
Sacramento, CA 95814

Dear Mr. Genest:

**Final: Department of Finance—Internal Control Review**

Enclosed is our final report on the Department of Finance's (Finance) internal control as of October 20, 2005. Finance's Office of State Audits and Evaluations performed this review in accordance with the Financial Integrity and State Manager's Accountability Act of 1983, Government Code Section 13400 et seq.

Finance's written response is included herein. Implementation of the proposed corrective actions will help strengthen Finance's internal control and reduce the risk of errors or irregularities

In accordance with Finance's policy of increased transparency, the final report will be placed on the Finance website. We appreciate the assistance and cooperation of staff and management during our review. If you have any questions, please contact Susan M. Botkin, Manager, or Dennis Mehl, Supervisor, at (916) 322-2985.

Sincerely,

Original signed by Diana L. Ducay

Diana L. Ducay, Chief  
Office of State Audits and Evaluations

Enclosure

cc: Mr. Stephen W. Kessler, Chief Operating Officer, Department of Finance  
Mr. Thomas E. Dithridge, Program Budget Manager, Department of Finance  
Ms. Debbie Chambliss, Chief, Administrative Services, Department of Finance

# AN INTERNAL CONTROL REVIEW

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Department of Finance

Prepared By:  
Office of State Audits and Evaluations  
Department of Finance

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The Director of the Department of Finance (Finance) serves as the Governor's chief fiscal policy advisor with emphasis on the financial integrity of the state and maintenance of a fiscally sound and responsible Administration.

The objectives of the Department of Finance are:

- To prepare, present, and support the annual financial plan for the state
- To assure responsible and responsive state resource allocation within resources available
- To foster efficient and effective state structure, processes, programs, and performance
- To ensure integrity in state fiscal databases and systems

State managers are required to maintain internal control in the programs they administer. Internal control is defined as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. This definition of internal control includes five interrelated components:

- *Control environment* sets the tone of an organization, influencing the control consciousness of its staff. It is the foundation for all other components of internal control, providing discipline and structure.
- *Risk Assessment* is the entity's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Control Activities* are the policies and procedures that help ensure management directives are carried out.
- *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- *Monitoring* is the process that assesses the quality of internal control performance over time.

The objective of our internal control review was to assist Finance in complying with the Financial Integrity and State Manager's Accountability Act of 1983. Specifically, we assisted Finance in determining whether: (1) assets are safeguarded from unauthorized use or disposition, (2) financial transactions are executed in accordance with management's authorizations and recorded properly to permit the preparation of reliable financial statements, and (3) financial

operations are conducted in accordance with State Administrative Manual guidelines, and certain other state laws and regulations, as well as Finance's policies and procedures.

This report is intended for the information and use of Finance and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

**STAFF:**

Susan M. Botkin, CGFM  
Manager

Dennis Mehl  
Supervisor

Angie Miller  
Michael Bratman  
Derk Symons

## EXECUTIVE SUMMARY

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During our review of the Department of Finance's (Finance) internal control, we identified several areas where controls were in place and working as intended. We also identified areas where controls could be improved to reduce the risk of errors, irregularities, and material misstatements. We met with management and staff to discuss the following weaknesses, as well as other non-reportable findings and observations.

The Department of General Services, Contracted Fiscal Services (CFS) provides most of the accounting functions for Finance. Therefore, the following comments are limited to functions or activities performed by Finance.

*Fixed Assets:* Finance's internal controls over property are insufficient to ensure an accurate listing of its fixed assets. We found that Finance does not have an accurate and complete listing of non-information technology property and does not tag all equipment. *For further analysis, see the Findings and Recommendations section of this report.*

*Information Security:* Finance has adequate computer use controls over information security including effective computer use policies, related training, and monitoring. However, we observed that data has not been formally classified in writing and there is no duty statement for the Information Security Officer. *For further analysis, see the Findings and Recommendations section of this report.*

*Contracts:* Finance's internal controls for contracts appear adequate. We observed the implementation and maintenance of current policies and procedures, and adequate separation of duties over the contract function. However, Finance did not provide evaluations on consultant contracts. *For further analysis, see the Findings and Recommendations section of this report.*

*Budget:* Finance's internal controls over its budget functions appear adequate. Finance maintains current policies and procedures and budget changes are properly approved.

*Cash Receipts:* Controls over cash receipts are adequate to ensure the proper safeguarding of state assets.

*Receivables:* The Department's internal controls over accounts receivables are adequate.

*Purchasing:* Finance's internal controls over purchasing are sufficient to ensure that purchases of goods and services are properly authorized and made in accordance with state policies. Finance's assets are appropriately safeguarded when received.

*Cash Disbursements:* Finance's internal controls over its limited cash disbursement functions are adequate.

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*Revolving Fund:* Finance's internal controls over its limited revolving fund functions are sufficient to appropriately safeguard state assets.

*Personnel/Payroll:* Finance's internal controls over the personnel and payroll functions appear adequate to ensure the reliability and integrity of data. Finance's appointment and separation procedures, and separation of duties over personnel and payroll transactions are adequate.

*Financial Reporting:* Finance's internal controls over financial reporting appear adequate. Required financial statements and reports are properly prepared and certified.

This report is intended to assist Finance's management in focusing attention on areas of risk and in strengthening internal control and improving operations.



## AUDITOR'S REPORT

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Mr. Michael C. Genest, Director  
Department of Finance  
State Capitol, Room 1145  
Sacramento, CA 95814

We have reviewed the Department of Finance's (Finance) internal control as of October 20, 2005, for conformity with Government Code Section 13400 et seq. Our review included obtaining an understanding of internal control through observations and interviews, identifying risks, testing and evaluating the design and operating effectiveness of the internal control, and performing other procedures we deemed necessary under the circumstances.

Finance's management is responsible for establishing and maintaining adequate internal control. This responsibility, in accordance with Government Code Section 13400 et seq., includes documenting internal control, communicating control requirements to employees, and assuring that the internal control is functioning as prescribed. In fulfilling its responsibility, management is required to assess the expected benefits and costs of its control procedures.

The objectives of internal control are to provide reasonable, but not absolute, assurance that:

- Assets are safeguarded against loss from unauthorized use or disposition.
- Transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of reliable financial statements.
- Financial operations are conducted in accordance with policies and procedures established in the State Administrative Manual, and certain other state laws and regulations, as well as Finance's policies and procedures.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any review of internal control to future periods are subject to the risk that the internal control may become inadequate because of changing conditions, or that compliance with control policies or procedures may decline.

In reviewing Finance's internal control as of October 20, 2005, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the Finance's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

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A material weakness is a condition that precludes Finance's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented, or detected on a timely basis. We believe the reportable condition concerning fixed assets is a material weakness. This weakness and other reportable conditions are described in the *Findings and Recommendations* section of this report.

This report is intended for the information and use of Finance's management, and is not intended to be used by anyone other than the designated parties. However, this report is a matter of public record and its distribution is not limited.

Original signed by Diana L. Ducay

Diana L. Ducay, Chief  
Office of State Audits and Evaluations  
(916) 322-2985

October 20, 2005

## FINDINGS AND RECOMMENDATIONS

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We reviewed the accounting and administrative controls within the Department of Finance (Finance). During our review, we noted that a number of controls were functioning as intended. However, we also identified areas where controls are not in place and where corrective action is necessary, as described below.

### Fixed Assets

The combination of accurate accounting records and strong internal controls must be in place to protect against and detect the unauthorized use of state property. We identified the following material weaknesses relating to the property inventory.

#### **FINDING 1                      Inventory is Not Being Recorded and Equipment is Not Properly Tagged**

Condition:                      Finance does not maintain adequate non-information technology property accounting records nor is equipment properly tagged.

Criteria:                        State Administrative Manual (SAM) Section 8650 provides that departments will record the following information when property is acquired:

1. Date acquired
2. Property description
3. Property identification number
4. Cost or other basis of valuation
5. Owner fund
6. Rate of depreciation (or depreciation schedule) if applicable.

Departments will keep track of state property, whether capitalized or not, in an automated property accounting system (if one is used) or on Property Record Cards.

Sam Section 8651 requires that all state property to be tagged after acquisition to designate the assets as belonging to the state.

Recommendations:        Implement a property accounting system to record required information on both capitalized and non-capitalized equipment, and properly tag all equipment after acquisition.

### Information Security

Effective information security controls are necessary to ensure compliance with the state's security and data integrity policies. We observed the following weaknesses relative to information security.

**FINDING 2                      Data Has Not Been Formally Classified in Writing**

- Condition:                      Finance's data has not been formally classified in writing. Although personal information has been classified as confidential, there is budgetary data and documents that are often considered confidential. Finance's Administrative Policy Manual or other official guidelines do not state when and what data is confidential versus public. Agencies are required to classify data elements as public, confidential or sensitive.
- Criteria:                        SAM Section 4841.2 requires each agency to provide for the integrity and security of its automated files and databases by ensuring that each automated file or database is identified as to its information class (SAM Section 4831.3) in accordance with law and administrative policy.
- Recommendation:            Classify Finance's data to protect against unauthorized access and disclosure.

**FINDING 3                      No Job Description for Information Security Officer**

- Condition:                      Finance does not have a specific charter or job duties for the functions and duties of the Finance Information Security Officer (ISO). The job expectations, authority, and duties are not clearly defined in writing.
- Criteria:                        SAM Section 4842.2 indicates that an agency's information security and risk management practices include written documentation of specific responsibilities.
- Recommendation:            Create and formalize the charter of the Information Security Officer. A written charter or job duty statement for the ISO should be developed and approved by Finance's executive management.

**Contracts**

Overall, Finance's internal controls over its contracts are adequate. Contracts are used for acquiring specialized services including maintenance, legal, and consulting services. We identified the following weaknesses in controls over contracts.

**FINDING 4                      Finance Does Not Complete Contractor Evaluations**

- Condition:                      The three completed consultant contracts we tested did not include the required consultant evaluation.
- Criteria:                        State Contracts Manual 3.02 requires an evaluation to be completed at the conclusion of a consultant contract.
- Recommendation:            Prepare an evaluation of consultants within 60 days of contract completion.

## CONCLUSION

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Our review of Finance's internal control presents opportunities for Finance's management to correct identified weaknesses and improve its operations. We believe internal control would be strengthened and Finance would operate more effectively if it implements our recommendations. The reportable conditions, if left uncorrected, increase the risk that material errors or irregularities could occur and remain undetected; and the material weakness, if left uncorrected, could adversely affect Finance's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The findings in this report are based on fieldwork performed between September 6, 2005 and October 20, 2005. We presented these findings to the related divisions and units at the completion of each cycle and at the exit conference held on November 7, 2005.





**DEPARTMENT OF  
FINANCE**  
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December 29, 2005

Ms. Diana L. Ducay, Chief  
Office of State Audits and Evaluations  
Department of Finance  
300 Capitol Mall, Suite 801  
Sacramento, CA 95814

Dear Ms. Ducay:

Thank you for the opportunity to respond to the Draft Audit Report on the Department of Finance's Internal Control Review.

We appreciate the efforts of your audit team to assist us in improving our internal controls and processes. Enclosed are the responses to the specific findings. As indicated in these comments, we feel that the recommendations incorporated in the report will assist us in improving our administrative activities.

If you have any questions, please contact Debbie Chambliss, Chief of Administrative Services at 445-3274.

Sincerely,

Original signed by Vincent P. Brown

MICHAEL C. GENEST  
Director

Enclosure

cc: Stephen W. Kessler  
Thomas E. Dithridge  
Debbie Chambliss

**DEPARTMENT OF FINANCE**  
**Response to Draft Audit Report – Internal Control Review**  
December 29, 2005

Finding	Current Condition	Criteria	Recommendation	Finance Response
1	Inventory is not being recorded and equipment is not properly tagged.	SAM 8650	Implement a property accounting system to record required information on both capitalized and non-capitalized equipment, and properly tag all equipment after acquisition.	Finance concurs with the finding. We have performed a complete physical inventory and identified equipment not properly tagged. Staff have been instructed to tag those items, as well as follow the SAM guidelines for future acquisitions. Property Management software has been ordered to assist in tracking both capitalized and non-capitalized inventory.
2	Data has not been formally classified in writing.	SAM 4841.2	Classify Finance's data to protect against unauthorized access and disclosure.	Finance concurs with the finding and will develop a data classification policy for review and approval of executive management. The policy will define when and what data are public, confidential or sensitive.
3	No job description for Information Security Officer.	SAM 4842.2	Create and formalize the charter of the Information Security Officer. A written charter or job duty statement for the ISO should be developed and approved by Finance's executive management.	Finance concurs with the finding and will develop a written charter for the review and approval of executive management. The charter will document the expectations and high-level duties of the Finance ISO.
4	Finance does not complete contractor evaluations	State Contracts Manual 3.02	Prepare an evaluation of consultants within 60 days of contract completion.	Finance concurs with the finding and already completed the required consultant evaluations. Staff have been reminded to ensure timely completion of contractor evaluations as required.